

**TESTIMONY OF DR. JANET YELLEN
CHAIR, COUNCIL OF ECONOMIC ADVISERS
BEFORE THE U.S. SENATE COMMITTEE ON FINANCE**

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Mr. Chairman and members of the Committee. Thank you for the opportunity to discuss the trade deficit with you today.

The trade deficit is an important economic statistic, but its interpretation is subject to substantial confusion. A country's trade balance is often--wrongly--used as a measure of the success of its market-opening policies or the benefits of its engagement in international trade. The most important idea I would like to express to you today is that the benefits of increased international trade are reflected in higher real income, not in a smaller trade deficit. Indeed, the rising U.S. trade deficit in recent years mainly reflects the strength of the American economy, which has grown rapidly in comparison with the economies of many of our trade partners. In part, the trade deficit reflects the fact that our fast-growing economy is pulling in a lot of imports. But at the same time it also reflects the fact that the U.S. is attracting substantial international capital flows. These have financed increases in plant and equipment investment that have exceeded even the growth in national saving due to deficit reduction since the beginning of the Clinton Administration.

I. The Benefits of Trade

Going back to Adam Smith, one of the most important insights of economics is that international trade increases the real incomes of all countries that engage in it. Trade is not a zero-sum game in which the gains of some countries come only at the expense of other countries. To the contrary, trade is a positive-sum game in which both sides gain.

For a long time, arguments for trade were based on the principle of *comparative advantage*. When countries specialize in the economic activities for which they are particularly well-suited and rely on trade to acquire other goods, they can achieve a higher standard of living than if they try to produce everything themselves. More recently, economists have argued that trade can also enhance productivity through the effects of greater market size, enhanced competition, and importation of new ideas and technologies.

These benefits from trade are not merely theoretical. A large and growing economics literature has found that those countries that are open to trade tend to grow faster and have higher levels of per-capita income than countries that close themselves off from international competition and trade. One estimate is that the globalization of the U.S. economy over the last 40 years has added about \$1500 to per-capita income.

Because policymakers in this country have long believed in the benefits of trade for all parties, the United States has long been the world's leading advocate for trade liberalization. U.S. tariffs are among the lowest in the world. While we benefit directly from our own low tariffs--through lower prices to consumers-- we would benefit even more if other countries were to lower their tariffs and other trade barriers. Since U.S. trade barriers are already so low, international trade agreements typically produce much larger reductions in the trade barriers facing American goods in foreign markets than on foreign goods in the United States.

It is often suggested that the major benefit of trade liberalization is job creation. When our economy is operating below its potential, with slack in the job market, export growth can produce job gains, helping the economy move toward full employment. As of January 1993, for example, the economy had substantial unemployment and excess capacity. One could say that the large increase in U.S. exports between 1993 and

1997--roughly 10% per year at an annual rate-- accounted for 38 percent of the increase in output, and a proportionate share of the almost 16 million jobs that were created over that period. In the long-term, however, increases in exports must ultimately pull workers away from other activities. Trade still raises real income, but the boost comes from better jobs and not from more jobs. Studies show that export jobs pay 13-18 percent more than other jobs. Indeed, export jobs are better even after adjusting for worker skills and firm-specific and industry-specific components to wages.

II. Macroeconomics and the Trade Deficit

Perhaps the greatest source of confusion about trade relates to the interpretation and causes of trade deficits and surpluses.

A trade deficit occurs, by definition, when a country's total domestic spending exceeds its total domestic production. When this occurs, the shortfall is made up by importing more goods than are exported. When the U.S. runs a trade deficit, foreigners buy less than a dollar's worth of U.S. goods for every dollar they earn from their export sales to us. The natural question is, what motivates foreigners to supply us with more goods than we supply to them in exchange? And what do foreigners do with the dollars that they don't use to buy U.S. goods? In practice, foreigners typically use the excess dollars to invest in interest-bearing U.S. assets. Indeed, it is the desire of foreigners to purchase attractive U.S. assets--to lend us the money needed to finance a trade deficit--that makes it possible to run such a deficit. Countries can run deficits only if foreigners want to add to their holdings of the deficit country's assets. In fact, one can as readily argue that the desire of foreigners to acquire attractive U.S. assets is responsible for the U.S. trade deficit as the reverse.

This relationship between spending, production, and the trade deficit can be expressed another way. I will not bore you with the details but it turns out that in an accounting sense a country's current account balance (a comprehensive measure which comprises not only the balance of trade balance in goods and services but also net investment income and transfers) is equal to the difference between national saving and national investment. The attached chart illustrates this relationship. When the demand for investment in the United States exceeds the pool of national saving, the difference is made up by borrowing from foreigners. Conversely, when saving exceeds investment, the surplus is invested abroad. The United States first experienced large current account deficits during the mid-1980s, when net investment fell as a share of national income and net national saving fell even faster. The deficit shrank briefly as investment collapsed in the 1990-91 recession, but it has reemerged in the current expansion. The good news in this expansion is that investment has been booming. But saving does not appear to have kept pace, despite the improvement due to federal deficit reduction. (The interpretation of current trends in saving, investment, and the current account is complicated by the statistical discrepancy between GDP measured as the sum of all spending on output and as the sum of all income generated in producing that output.)

When a trade deficit is used to finance productive investment, as it is now, it can be viewed as largely benign, because the extra investment raises the productivity of our workforce, resulting in higher future national income. It is that return that should enable us to pay off the foreign borrowing we have undertaken to help finance our investments. We would be worse off as a nation, and our interest rates would have been higher if, over the last few years, we had been forced to curtail our investment. Our ability to attract funds from abroad is a vote of confidence in the ability of our high-performing economy to put these funds to good use.

Let me return now to the more immediate causes of our rising trade deficit. A key factor responsible for this trend is strong growth in the United States relative to some of our major trading partners. Our strong growth has resulted in a larger income-induced increase in American demand for foreign goods than in foreign demand for our goods and services. The second key factor is the dollar's appreciation, which has been substantial over the last three years. In a system of flexible exchange rates and high capital mobility, an appreciation in a currency reflects a desire by foreigners to hold that currency. Appreciations very often accompany strong economic expansions like the one the U.S. has experienced over this period, and in that

sense the appreciation of the dollar is unsurprising given that the U.S. economy has grown much more rapidly than those of many of our trading partners over the past few years.

More recently we have seen a surge in the trade deficit that reflects the effects of the East Asian crisis. Sharp drops such as those seen in the value of the East Asian currencies lead to an increase in U.S. demand for the goods produced by these countries (which are now much cheaper to us than before). At the same time, the East Asian countries have cut back sharply on imports of goods from the U.S. both because our goods are effectively much more expensive for them, and also because their incomes have fallen substantially.

Our sales to these countries have fallen sharply. Data for the first three months of this year show that our exports to the five most-affected countries are down between \$17 billion and \$21 billion (annualized) since the crisis began, depending on how one does the seasonal adjustment. Roughly two-thirds of the lost sales were to Korea. Exports to Japan are down another \$6 to \$8 billion over this period. Thus the total adverse movement across all six countries has been \$23 to \$29 billion. We expect the loss in sales to worsen during the remainder of the year, especially if Asian economies continue to contract. Furthermore, we have not yet seen the large increase in imports from the Asian countries that their devaluations are likely to produce.

It is often argued that the Asian crisis, by decreasing U.S. net exports, will diminish U.S. growth over the next year or longer. There is no denying that net exports are exerting, and will continue to exert, a drag on U.S. economic growth. Fortunately, however, the slowdown in exports to East Asia is affecting the U.S. economy at a time when domestic demand growth is extremely robust and labor markets have becoming increasingly tight. The consensus among forecasters is that the East Asian crisis could serve as the brake that subdues growth toward a more sustainable pace, preventing overheating, and permitting continued job growth with a more moderate path for interest rates and stronger investment spending than we would otherwise enjoy. There is the further side-benefit that the sharp declines in Asian currencies and the consequent decline in the dollar price of imports from that region will provide a dampening influence on inflation.

III. Are There Reasons for Concern?

My testimony so far has been that the trade deficit largely reflects the strength of the American economy. But I do not want to leave you with the impression that there are no reasons to be concerned about a large trade deficit.

First, even in the absence of any negative aggregate impact on output and employment due to a growing trade deficit, particular sectors have been adversely affected. Before 1997, many U.S. producers enjoyed rapid growth in their exports to East Asia. That has now disappeared. As I have already noted, exports are down sharply to Asia in general, and to Korea, Southeast Asia, and Japan, in particular. They can be expected to continue to fall in the remainder of this year. In addition, we will probably see increased imports from these countries, especially in such sectors as autos, steel, textiles and apparel, and semiconductors and other electronics. The crisis countries have no choice but to shift their trade balances into surplus, since they are no longer able to borrow from abroad to finance the trade deficits that most of them ran before the crisis. It is their inability to borrow in world capital markets that is responsible for the currency depreciations and income reductions that are in turn causing them to buy less from us and sell more to us.

The second reason for concern about our growing trade deficit follows in part from the first. Our rising trade deficit, particularly in such key areas of the economy as manufacturing and agriculture, could undermine support for internationalist principles and for market-opening policies like those outlined by Secretary Rubin in his testimony. If the widening U.S. trade deficit were to create the false impression that the U.S. stands to lose rather than to gain from continued engagement in international markets, then it would be a costly development indeed.

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